

**The Florida Senate**  
**BILL ANALYSIS AND FISCAL IMPACT STATEMENT**

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

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Prepared By: The Professional Staff of the Policy and Steering Committee on Ways and Means

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BILL: CS/CS/CS/SB 1078

INTRODUCER: Policy and Steering Committee on Ways and Means, General Government  
Appropriations Committee, Governmental Oversight and Accountability Committee, and  
Senator Ring

SUBJECT: State Financial Matters

DATE: April 15, 2010

REVISED: \_\_\_\_\_

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Wilson	Wilson	GO	<b>Fav/CS</b>
2.	Gizzi	Yeatman	CA	<b>Fav/1 amendment</b>
3.	McVaney	DeLoach	GA	<b>Fav/CS</b>
4.	McVaney	Coburn	WPSC	<b>Fav/CS</b>
5.				
6.				

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**Please see Section VIII. for Additional Information:**

A. COMMITTEE SUBSTITUTE.....	<input checked="" type="checkbox"/>	Statement of Substantial Changes
B. AMENDMENTS.....	<input type="checkbox"/>	Technical amendments were recommended
	<input type="checkbox"/>	Amendments were recommended
	<input type="checkbox"/>	Significant amendments were recommended

**I. Summary:**

This bill makes a number of conforming changes to the optional defined contribution pension plan in the Florida Retirement System regarding the proper nomenclature of the plan, how participant communications are disseminated, the retention and recognition of excess account balances, the retention of participant records by the third-party administrator, the duration of retained participant forfeiture amounts, the liability for extraordinary acts that result in participant losses, and the ownership of intellectual property for products developed by the Board of Administration (Board). The bill also revises the operating practices of the Board of Administration to provide additional audit services, periodic training in fiduciary duty matters, and specific ethics standards for investment managers and financial advisers under contract to the board. It prescribes additional duties and qualifications for these members and the executive director of the board.

This bill substantially amends the following sections of the Florida Statutes: ss. 121.4501; 121.4502; 121.591; 121.74; 121.78; 215.44; 215.441; 215.442; 215.444; 215.47; 215.52; and 218.409. The bill creates ss. 215.4754 and 215.4755, Florida Statutes.

## II. Present Situation:

### **The Public Employee Optional Retirement Program**

The Florida Retirement System (FRS) is composed of two programs: The Defined Benefit Program (FRS Pension Plan) and the Defined Contribution Program (FRS Investment Plan), properly known as the Public Employee Optional Retirement Program (PEORP). The term ‘defined contribution’ for the FRS Investment Plan means that employer *contributions* are defined; whereas in the FRS Pension Plan, the *benefit* is defined.<sup>1</sup>

The FRS Investment Plan shifts the investment risks from the employer to the employee by allowing the individual employee to select and manage the investment options- similar to private 401(k) plans. Unlike the Pension Plan, benefits under the Investment Plan vest after only one year of service and are portable to other employer’s plan or private 401(k) plans. Since the value of employee benefits under the Investment Plan are subject to changes in the market, improper planning or poor market performance can cause some employees to outlive their benefits. Employees under the FRS Investment Plan are not eligible to participate in the Deferred Retirement Option Program (DROP) and cannot receive a Health Insurance Subsidy (HIS) until they reach the age of 62 (55 for Special Risk members).<sup>2</sup>

The FRS is administered by two state agencies: The Department of Management Services and the State Board of Administration. The Department of Management Services’ Division of Retirement provides administrative services which include: recording membership enrollments, receiving employer contributions, monitoring the trust fund, calculating retirement benefits, and publishing the annual actuarial report. The State Board of Administration<sup>3</sup> is primarily responsible for overseeing and investing FRS pension benefits to ensure sufficient investment returns and administering and approving programs under the FRS Investment Plan. Both agencies monitor the MyFRS Financial Guidance Program and retirement plan educational programs.

### **The State Board of Administration**

The State Board of Administration (SBA) is comprised of the Governor, Chief Financial Officer and Attorney General.<sup>4</sup> The SBA manages thirty-six separate statutory investment portfolios, the largest one of which is the multi-employer Florida Retirement System. The SBA must invest and reinvest available funds of the System Trust Fund in accordance with the specified statutory provisions.<sup>5</sup> The System Trust Fund is the trust fund established by statute in the State Treasury for the purpose of holding and investing the contributions paid by members and employers and paying the benefits to which members or their beneficiaries may become entitled.<sup>6</sup> Other trust funds may be established in the State Treasury to administer the System Trust Fund. In making

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<sup>1</sup> MyFRS FRS INVESTMENT PLAN SUMMARY PLAN DESCRIPTION, (July 1, 2009) *available at* [http://www.myfrs.com/imageserver/pdf/forms/frs\\_ip\\_spd.pdf](http://www.myfrs.com/imageserver/pdf/forms/frs_ip_spd.pdf) (last visited on Feb. 24, 2010) [emphasis added].

<sup>2</sup> MyFRS, PLAN COMPARISON CHARTS: THE FRS INVESTMENT PLAN, *available at* [http://www.myfrs.com/portal/server.pt/community/comparing\\_the\\_plans/235](http://www.myfrs.com/portal/server.pt/community/comparing_the_plans/235) (last visited on Feb. 24, 2010).

<sup>3</sup> The State Board of Administration consists of the Governor, the Chief Financial Officer, and the Attorney General. *See* Florida State Board of Administration (SBA), *available at* <http://www.sbafla.com/fsb/> (last visited on March 1, 2010).

<sup>4</sup> Section 16, art. IX, Constitution of 1885, and continued by s. 9, art. IX, State Constitution, as revised in 1968 and subsequently amended.

<sup>5</sup> Section 121.151, F.S.

<sup>6</sup> Section 121.021(36), F.S.

investments for the System Trust Fund the board may not make any investments not in conformance with the Florida Retirement System Defined Benefit Plan Investment Policy Statement.<sup>7</sup>

The SBA also manages investments on behalf of the Hurricane Catastrophe Fund, the Florida Lottery, the Pre-Paid College Fund, its own separately constituted Division of Bond Finance, and pooled money market funds for local governments (Florida Prime), among others. Assets under management on March 4, 2010, totaled \$139 billion.

The Trustees and agency investment personnel are named fiduciaries for the management of funds under their control. As such, they must adhere to the duties of prudence, loyalty, sole and exclusive benefit in the discharge of their responsibilities. The SBA also houses a statutory Investment Advisory Council whose purpose is to provide the staff and Trustees with non-fiduciary advice on trends and conditions in the institutional investment marketplace. The SBA participates with its peer plans in a number of institutional investor organizations on matters affecting national and international finance.

Since the congressional passage of the Sarbanes-Oxley Act of 2002, Pub.L. 107-204, increased attention has been devoted toward the duties of auditors and fiduciaries in general. Successive changes to world financial markets beginning in late 2007 only accelerated the scrutiny devoted to institutional financial organizations in both public and private sectors. At that time the SBA's Local Government Investment Pool, since renamed Florida Prime, experienced a wave of redemptions by subscribing local governments. A number of the financial instruments contained in this money-market pool were commercial paper, collateralized mortgage obligations, and collateralized debt obligations. They were rated as investment grade at the time of purchase but their components, that is, the separate mortgages and debt securities, rapidly declined in value due to an overleveraged market. The pace of the redemptions saw the fund balance fall from \$26.2 billion in October 2007 to \$9.8 billion only two months later as liquidity concerns gripped its members. At the end of January 2010, the fund balance was \$6.3 billion. Subsequent reviews of the circumstances affecting this loss of liquidity led the 2008 Legislature to create a separate advisory structure for the pooled funds. An investigation of these circumstances was also undertaken by the Securities and Exchange Commission and on March 3, 2010, that federal agency closed the investigative file with no action indicated.

In response to this series of events the SBA staff commissioned a review of its organizational configuration and investment controls. That report, Governance Research Project, was issued on September 9, 2009, and compared and contrasted the SBA's structure and professional competencies among a peer group of ten state-level institutional pension plans. The specific dimensions analyzed were board composition, pension and non-pension mandates, selection of investment managers, budget approval, governance structure, and meeting frequency. In the period since the release of the report two of the SBA Trustees have separately made recommendations for statutory changes in the areas of board and investment advisory composition and meeting frequency. Both trustees have indicated in separate communications that an enhanced internal and external audit commitment would be welcome.

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<sup>7</sup> Section 215.475(1), F.S.

### III. Effect of Proposed Changes:

The bill represents altered administrative practices as well as financial policy changes for parties responsible for gains and losses in participant accounts under defined circumstances. The bill also makes procedural changes to the time frame for extraordinary meetings of the Trustees relative to the authority provided in s. 218.409, F.S., in their management of a multi-employer pooled cash management account. Rapid depletions from the corpus of that account in late 2007 required suspension of participant employer redemptions until its liquidity could be reestablished.

**Section 1** amends s. 121.4501(4), F.S., to provide nomenclature, grammar, and syntax changes and definition amendments for terms used under the FRS Investment Plan in ch. 121, F.S. The responsible state agencies are uniformly designated by their short titles of “department,” “division,” or “board, or “optional program,” the latter in lieu of PEORP.

Persons transferring membership from the Investment Plan to the Pension Plan who have excess account balances may not receive a distribution of the excess until retirement although they may allocate the excess to the purchase of extra service credit.

Subsection (8) is amended to give clearer specific authorization to the Board to adopt rules to execute its statutory duties on the management of the Investment Plan and to develop procedures for the receipt and action on participant complaints on the plan administrator or vendors. The third-party administrator is required to have a records retention capability of at least five years. Actions on complaints greater than five years are presumed to be correct unless the participant can present written or recorded documentation to the contrary.

Subsection (14) is amended to require the investment policy statement of the defined contribution plan must be approved by the Investment Advisory Council.

**Section 2** amends s. 121.4502, F.S., to require the creation of a subaccount to hold amounts forfeited by participants. The funds in the subaccount must be used to offset expenses or to reduce employer contributions.

**Section 3** amends s. 121.591, F.S., to recognize forms of communication other than written applications for the receipt of benefits.

**Section 4** amends s. 121.78, F.S., to make nomenclature changes to the references to the participating units of government and also to indemnify the state agencies responsible for posting contributions to an employee account if the agencies are delayed due to acts beyond their control.

**Section 5** amends s. 215.44, F.S., to authorize the board to invest the funds on behalf of any state university or college or a direct support organization of any state agency, university or college, or local government. In addition, this section makes nomenclature changes and requires the SBA to maintain a salary and benefit structure for its employees consistent with that contained in s. 110.205, F.S., and exempt from the Career Service System. The Investment Advisory Council is directed to hire a private consulting firm to conduct such compensation studies as may be required, not less often than every five years, to establish competitive total compensation. The

section establishes an audit committee to direct the efforts of the board's auditors and prescribes the appointments for the designated members. The auditing committee shall consist of 3 members that are each appointed for 4-year terms. Each year the board shall produce financial statements for the Florida Retirement System for the Legislature and a commercial independent third-party audit firm. The board must meet at least quarterly and shall receive reports from the: audit committee, investment advisory committee, inspector general, general counsel, executive director, and others.

**Section 6** amends s. 215.441, F.S., to provide specific qualifications for the SBA's executive director which must include relevant experience in the institutional management of fiduciary funds. The board must appoint a search committee before the appointment of an executive director, whose salary must be set by the board. The appointment of the executive director will be by majority vote of the Trustees.

**Section 7** amends s. 215.442, F.S., to include the Investment Advisory Council as a recipient of quarterly reports on downgraded securities and to affirm its role as a resource to the plan trustees.

**Section 8** amends s. 215.444, F.S., to require the Investment Advisory Council to meet with staff of the board and provide a quarterly report to the trustees. This section revises the experience and training requirements of the Council members. Sovereign immunity waivers that apply to the torts of government employees under s. 768.28, F.S., apply to Council members.<sup>8</sup> Any council recommendations must be based upon fiduciary standards. The Council must also approve subsequent Investment Policy Statements, participate in the selection process for the executive director, engage in compensation studies, and provide recommendations. The Council must meet quarterly to review the performance of investments. The Council may create subcommittees or hire independent contractors to carry out Council responsibilities.

**Section 9** amends s. 215.47, F.S., to expand the investment options. Under this section, the Board may invest in debt instruments authorized by the Hurricane Catastrophe Fund under s. 215.555(6), F.S., and use the proceeds of debt issued under s. 215.555, F.S., to purchase authorized and registered securities. This section also authorizes an increase from 25 to 35 percent in the permitted holdings of foreign securities in its investment portfolios.

**Section 10** amends s. 215.475, F.S., to provide for approval of the Investment Policy Statement by the Investment Advisory Council.

**Section 11** creates s. 215.4754, F.S., to provide ethics requirements related to specific individual economic benefits that may accrue to investment advisors, managers, or members of the Investment Advisory Council.

**Section 12** creates s. 215.4755, F.S., to require investment advisers or managers who contract with the state to develop and abide by a written code of ethics. These private advisers/managers have discretion to develop their own code but it must include criteria such as:

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<sup>8</sup> Note that this provision codifies an Attorney General Opinion that held that members of the Council were government employees for the purposes of sovereign immunity. Fla. Att'y Gen. Op. 02-26 (March 27, 2002).

- Officers and employees shall refrain from personal business activity that could conflict with the proper execution and management of the investment program and could impair their ability to make impartial decisions.
- Officers and employees shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the board.

All investment decisions made on behalf of the trust fund and the board must be made “in the best interest” of the trust fund and the board. The private entities must confirm that they have appropriate safeguards in place to avoid influences that would result in adverse investment decisions. Each year these investment advisers and managers must certify in writing that they are complying with these ethics requirements. These investment advisers or managers must disclose any conflict of interest, and, at the request of the board, any nonconfidential, nonproprietary information or pecuniary interests the investment adviser or manager has with any party to a transaction with the board.

**Section 13** amends s. 215.52, F.S., to expand the authority of the board to develop rules, policies, and regulations.

**Section 14** amends s. 218.409, F.S., to permit an extension beyond the current forty-eight hour moratorium on withdrawals and contributions to the Local Government Investment Pool, since renamed *Florida Prime*, when an emergency meeting of the Trustees cannot be convened within that time frame.

**Section 15** provides that the Board is authorized to develop work products that may be subject to various forms of intellectual property protections under its several statutory mandates and to license and enforce any of those protections on behalf of any of the separate trusts which may have been developed.

**Section 16** provides that this bill shall take effect on July 1, 2010.

#### **Other Potential Implications:**

There are indirect effects on local governments whose individual pension plans have investment policies that adopt the amendments to s. 215.47, F.S., by reference in their special acts or ordinances. This is discussed in greater detail in the Fiscal Impact Statement section below.

#### **IV. Constitutional Issues:**

##### **A. Municipality/County Mandates Restrictions:**

None.

##### **B. Public Records/Open Meetings Issues:**

Chapter 20, F.S., provides standard nomenclature on the classification of state governmental organizations. A committee is an entity created with a specific mission for a period not to exceed three years. This bill expands that nomenclature to confer upon an “audit committee” a continuing existence. While this may just be a misplacement of

terms, the functions of the committee imply regular responsibilities and meetings at which its business is formalized. The context may imply that these must be *noticed* meetings under ch. 286, F.S., as the audit committee is a subordinate unit of the SBA with a specific set of statutory responsibilities. Meeting records will be in the public domain unless otherwise exempted under ch. 119, F.S., or other relevant law.

C. Trust Funds Restrictions:

None.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

The expansion of portfolio limits on foreign asset classes will provide additional income opportunities to the managers retained for those classes given the higher expense structure to maintain those assets. To the extent that there is a rebalancing of portfolios within the equity classes, foreign and domestic, shifting from the domestic equity management with lower fees to foreign equity management with higher fees will constitute an increase in expenses to the plan sponsor.

The bill also anticipates an increase in contracting between the SBA and private auditors and investors. These private contractors would benefit financially from their contracts with the state.

C. Government Sector Impact:

The bill increases the responsibilities and powers of the SBA and the Investment Advisory Council. Implementing these responsibilities, including any rulemaking done pursuant to these provisions, will cost money. Creating the audit committee with the prescribed expertise will cost money. The SBA estimates that the additional expenses will be under \$100,000 annually. Contracting with private auditors and investors will cost money. However, private assistance managing government funds was determined to be one of the “best practices” for public finance as determined by the 2009 Governance Research Project and may help the state see a larger return on its investments.

Section 218.415, F.S., requires local governments to have an investment policy statement that guides the allocations of their funds not needed for immediate expenditure. In the absence of a written statement, a local government is restricted in its authorized investments. There are nearly 500 local government pension plans in Florida enacted either through special act or local ordinance. An unknown number of local governments have investment allocation standards that cross reference s. 215.47, F.S. One effect of the change to this section will permit, but not mandate, such plans to change their asset allocation concentration limits to increase their foreign asset holdings. Foreign markets tend to be more opaque, the securities have higher transaction costs, and the demands on local plan management will be more

pronounced. Extra caution will have to be exercised by these smaller plans, many of whom already have pronounced declining funded ratios, such that any rapid reallocation of their assets to such markets may increase the volatility and the costs of that decision.

The Board reports that there were 568 participants in the Investment Plan with excess account balances after their transfer from the Pension Plan. Such excesses occur due to superior investment performance above what is required to establish membership. The access to these excess balances is restricted, in part due to the effect of ch. 2009-209, Laws of Florida, as their receipt would constitute a distribution during a period of active service. This violates the Internal Revenue Code and is considered an in-service distribution. It would further cause the participant to have been effectively “retired,” involuntarily, under state law.

The bill authorizes the Board to purchase securities issued on behalf of public jurisdictions that are influenced by interest rate subsidies authorized under federal law. The most prominent of these are Build America Bonds. Less prominent are those authorized under pending federal legislation passed by the United States Senate on February 24, 2010. These Qualified School Construction Bonds would make an additional \$11 billion available for institutional investors. This authorization is not a purchase mandate, and the Board would be required to complete a due diligence review that confirmed these were securities suitable for purchase for its investment portfolios.

#### **VI. Technical Deficiencies:**

None.

#### **VII. Related Issues:**

On March 3, 2010, the Board received a presentation from one of its external consultants, Ennis Knupp, on factors to consider in the development of a revised investment policy statement for the defined benefit plan. The consultant’s presentation, entitled *Asset/Liability Study for the Florida Retirement System Defined Benefit Program*, provided several scenarios in which there is a significant reallocation of plan assets out of equities into fixed income securities. The effect will be to reduce long term growth opportunities, moderate volatility, and permit the servicing of liquidity needs of the plan as it matures and experiences rising claims for retirement benefit payments. On August 13, 2009, the Board requested a private letter Ruling from the Internal Revenue Service on the appropriateness of its hurricane bonds as governmental issuances. In anticipation of a favorable ruling, the provisions of s. 9 of this bill permit proceeds of these debt issuances to be invested in other governmental securities. These two different events have a common thread. It will be essential for the Board to demonstrate that these post-event catastrophe bonds maintain their tax-exempt status in the event of a significant weather event prompting their issuance. Because the Board is also the market-maker of these securities by law, it will be essential to demonstrate that any purchase of such fixed income securities by any of the other asset classes it manages is also reasonable, prudent, and for the sole and exclusive benefit of the participants.



**VIII. Additional Information:****A. Committee Substitute – Statement of Substantial Changes:**  
(Summarizing differences between the Committee Substitute and the prior version of the bill.)**CS/CS/CS by Policy and Steering Committee on Ways and Means on April 15, 2010:**

The committee substitute:

- Removes a provision from the bill that would have reduced the educational and administrative assessment fee paid to the SBA for the defined contribution retirement program.
- Requires the investment policy statement for the defined contribution plan must be approved by the Investment Advisory Council.
- Creates a separate and visible audit committee to provide the regular discipline in how funds are managed.
- Provides a greater role for the existing Investment Advisory Council—more proactive than reactive—to changing trends and conditions in world financial markets.
- Gives improved enforcement tools to the board to identify and sanction those outside investment advisors trying to engage in “pay to play” deals that work against the best interest for the board’s funds.
- Enhances ethical and financial disclosure standards for the key parties in SBA financial transactions.

**CS/CS by General Government Appropriations on April 6, 2010:**

This committee substitute (CS) adds the word “to” on line 571 of CS/SB 1078, when referring to collections due to the board in subsection (4). The CS authorizes the State Board of Administration to invest the funds of any state university or college or a direct support organization of any state agency, university or college, or local government.

**CS by Governmental Oversight and Accountability on March 2, 2010:**

The Committee Substitute expands the authority of the Board to purchase debt securities issued incidental to federal law changes authorizing infrastructure and school facility construction bonds.

**B. Amendments:**

None.